

Liquidity Stress Testing

Your Partner For What's Next

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Liquidity Stress Testing under new ESMA regulations

The European Securities and Markets Authority (ESMA) published their final set of Guidelines on Liquidity Stress Testing (LST) in September 2019. **These Guidelines are set to come into force from 30 September 2020.** There are several critical areas of focus which we have outlined below:

Focus areas	LST considerations
Who is in the scope?	<ul style="list-style-type: none"> Guidelines apply to all UCITS and AIFs (including Exchange Traded Funds (ETF) and Money Market Funds (MMF)). Existing regulations and ESMA guidelines applying exclusively to MMFs shall prevail over the LST Guidelines.
Overarching principles	<ul style="list-style-type: none"> Principles-based approach: LST should be adapted appropriately to each fund's characteristics; these include frequency of scenarios employed, investor behaviour assumptions, model complexity and ETF specifications. Independence: LST should be performed independently from front-line functions such as portfolio management.
Requirements	<ul style="list-style-type: none"> LST should be properly integrated into the fund's risk management framework and documented in an LST policy. Model managers should design suitably robust LST models for measuring both the liquidity of assets and the fund's liabilities. LST managers should have a strong understanding of the fund's liquidity risks, and overall liquidity profile.
Frequency of LST	<ul style="list-style-type: none"> LST must be carried out at least annually. However quarterly exercises are recommended as best practice. Individual fund characteristics may increase/decrease the frequency of the recommended regular LST. Ad hoc analysis should also be undertaken should the LST manager identify a material risk requiring timely assessment.
Scenarios	<ul style="list-style-type: none"> LST should employ both hypothetical and historical scenarios and should also consider low-probability, high impact scenarios where relevant. Reverse Stress Testing (RST) should also be employed where appropriate. RST should be used to simulate how assets would be liquidated in an extreme market event, and the consequences of such an event on the overall liquidity profile.
Benefits of LST	<ul style="list-style-type: none"> LST allows funds to: <ul style="list-style-type: none"> - assess the impact of market stresses on their overall liquidity profile; - anticipate activity in stressed market conditions; and - identify potential vulnerabilities. Early adoption and integration of LST will allow funds test the effectiveness and robustness of their LST framework and ensure integration into the risk framework ahead of the September 2020 deadline.

Key Regulatory Priorities

Priority area	Description
Framework & policy	<p>Regulators expect to see LST:</p> <ul style="list-style-type: none"> – Fully integrated into the existing risk management framework; – Subject to robust governance and oversight, (including clearly defined reporting and escalation procedures); and – Performed independently from front-line functions. <p>The Regulator will also expect to see LST documented in an LST policy, which is subject to periodic review.</p>
Scenarios & data	<p>Regulatory expectations are that LST should:</p> <ul style="list-style-type: none"> – Be tailored to the specificities of each fund's portfolio composition, investor behaviour, risk appetite etc. – Employ both historical and hypothetical scenarios; – Apply RST techniques, where appropriate; and – Incorporate low-probability, high-impact scenarios. <p>The LST Manager must respond to limitations related to the availability of data through using expert judgement and avoiding optimistic assumptions.</p>
LST models	<p>Regulators will expect any models used for LST to include:</p> <ul style="list-style-type: none"> – All relevant risk factors; – A suitable range of scenarios; – Monitoring of outputs and indicators; – Reporting of LST results to senior management; and – How the LST results are used in decision making.

How can KPMG support you?

Framework & policy

- Designing and integrating a liquidity risk management framework.
- Performing gap analysis on your existing framework, including governance, reporting and oversight procedures.
- Drafting an LST policy, based on the 12 principles in the ESMA LST Guidelines in combination with our knowledge of the industry.
- Performing gap analysis on your existing LST policy.

Scenarios & data

- Performing data quality assessments and/or remediation on data sets underpinning historical scenarios;
- Developing scenarios to be employed in the LST model;
- Developing RST parameters;
- Reviewing existing scenarios / RST, providing feedback on the appropriateness of the number of scenarios, type/severity, assumptions and/or inclusion of expert judgement.
- Performing benchmarking and independent assurance over the assumptions made by management.

LST models

- Developing an LST model appropriate to your fund characteristics;
- Model development based on principles in the LST Guidelines and industry best practice.
- We apply both quantitative techniques (data analysis, performance testing) and qualitative analysis (reg requirements, documentation, governance)
- Developing a reporting/output solution.
- Assessment of existing LST models, and/or reporting processes including validation where required.

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